October 14, 2011

Hon. Douglas Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments on Proposed Regulations Under Section 162(m)

Dear Commissioner Shulman:

Enclosed are comments on proposed regulations under section 162(m) concerning limitations relating to the deductibility of compensation in excess of $1 million. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

William M. Paul
Chair, Section of Taxation

Enclosure

cc: Emily S. McMahon, Acting Assistant Secretary (Tax Policy), Department of the Treasury
    William J. Wilkins, Chief Counsel, Internal Revenue Service
    J. Mark Iwry, Senior Advisor to the Secretary and Deputy Assistant Secretary for Retirement and Health Policy, Department of the Treasury
    George H. Bostick, Benefits Tax Counsel, Department of the Treasury
    Alan N. Tawshunsky, Deputy Division Counsel/Deputy Associate Chief (Tax Exempt and Government Entities), Internal Revenue Service
    Ilya E. Enkishev, Attorney, Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities), Internal Revenue Service
    Stephen B. Tackney, Special Counsel to the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities), Internal Revenue Service
ABA SECTION OF TAXATION
COMMENTS ON PROPOSED REGULATIONS
UNDER SECTION 162(m)

These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Adam B. Cohen and Andrew L. Oringer of the Employee Benefits Committee of the Section of Taxation. Substantive contributions were made by Dennis B. Drapkin, Joanne G. Jacobson, Andrew C. Liazos, Max J. Schwartz, Charmaine L. Slack and Marina Vishnepolskaya. The Comments were reviewed by Joni L. Andrioff, Employee Benefits Committee Chair. The Comments were further reviewed by James R. Raborn of the Section’s Committee on Government Submissions, by Kurt Lawson, chair of the Committee’s Quality Assurance Group, and by Pamela Baker, Council Director for the Employee Benefits Committee.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal income tax principles addressed by these Comments, no such member or the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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October 14, 2011
EXECUTIVE SUMMARY

On June 24, 2011, the Department of Treasury ("Treasury") and the Internal Revenue Service (the "Service") issued proposed regulations1 ("Proposed Regulations") under section 162(m)2, which propose to clarify certain aspects of the regulations under section 1.162-27, issued in 1995 (the "Regulations"). The preamble to the Proposed Regulations requested public comment on the proposals, and we appreciate the opportunity to make recommendations regarding the Proposed Regulations.

The deduction limitations of section 162(m) do not apply to performance-based compensation, including certain compensation provided by a corporation when it first becomes publicly traded. The Regulations provide that options and stock appreciation rights (together, "Stock Rights") granted under a shareholder-approved equity plan that states “the maximum number of shares with respect to which options or rights may be granted during a specified period to any employee” and that meets other requirements will be treated as performance-based compensation.3 The Proposed Regulations would clarify that this maximum number of shares must be explicitly expressed in the shareholder-approved plan as a per-employee limit, as opposed to a maximum for all employees in the aggregate.

The Regulations also provide for a transition rule in the case of a company that becomes publicly traded.4 This rule is stated to apply to Stock Rights and restricted stock granted during a transition period. The Proposed Regulations would clarify that the transition rule does not apply to arrangements providing for restricted stock units, phantom stock or similar equity interests (collectively, “Stock Units”) after the end of the transition period.

In the final Regulations:

1. We recommend that the Service add an explicit statement in the relevant portions of the final Regulations to make it clear that a plan providing the aggregate maximum number of shares with respect to which Stock Rights and other forms of stock-based compensation may be granted during a specified period to an individual, rather than specifying a separate maximum for each form of stock-based compensation, would satisfy the per-employee limit in Regulation section 1.162-27(e)(2)(vi)(A).

2. We recommend that the clarification of the per-employee limit be effective with respect to plans submitted for shareholder approval on or after August 8, 2011 (i.e., 45 days after publication of the Proposed Regulations); we recommend in the alternative that, if the foregoing

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2 References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code), unless otherwise indicated.
4 Reg. § 1.162-27(f).
proposal is not accepted, the proposed clarification be effective after the taxpayer’s first shareholder meeting that occurs at least 12 months after the publication date of the final Regulations.

3. We recommend that Stock Units, regardless of the manner of settlement, should be treated in the same manner as restricted stock for purposes of the special rule for stock-based compensation under Regulation section 1.162-27(f)(3).

4. We recommend that if the Proposed Regulations are finalized in a manner so that the settlement of Stock Units after the end of the Reliance Period is subject to the section 162(m) deduction limitation, the proposed limitation should only apply to Stock Units granted after the Proposed Regulations are published in final form; we recommend in the alternative that, if the foregoing proposal is not accepted, the proposed limitation should be effective after the taxpayer’s first shareholder meeting that occurs at least 12 months after the publication date of the final Regulations.

5. We recommend that Stock Units, regardless of the manner of settlement, should be treated in the same manner as restricted stock for purposes of the spinoff transition rule under Regulation section 1.162-27(f)(4); we recommend that, if they are not, the same general effective date approach as set forth in item 4 above should apply.
DISCUSSION

I. Per-Employee Limit on Options and Stock Appreciation Rights

Regulation sections 1.162-27(e)(2)(vi) and (e)(4)(iv) provide that Stock Rights granted under a shareholder-approved equity plan that states “the maximum number of shares with respect to which options or rights may be granted during a specified period to any employee” and that meets other requirements will be treated as performance-based compensation. The Proposed Regulations would clarify that the limit must be explicitly stated in the shareholder-approved plan as a per-employee limit.

1. Aggregate Limit on Equity Compensation

Issue

As noted above, the Regulations provide that a plan under which Stock Rights may be granted must state “the maximum number of shares with respect to which options or rights may be granted during a specified period to any employee.” An example in the Regulations appears to indicate that a plan may satisfy this requirement where it authorizes a combination of Stock Rights and restricted stock. However, other than that example, the Regulations do not make it explicit that this common approach of providing a share limit on the combination of various forms of stock-based compensation is permitted.

Recommendation

We recommend that the Service add an explicit statement in the relevant portions of the Regulations to make it clear that a plan providing the aggregate maximum number of shares with respect to which Stock Rights and other forms of stock-based compensation may be granted during a specified period to an individual, rather than specifying a separate maximum for each form of stock-based compensation, would satisfy the per-employee limit in Regulation section 1.162-27(e)(2)(vi)(A).

Explanation

In Example 11 under Regulation section 1.162-27(e)(2)(vii), the Service describes a plan that provides that “each participating employee may receive options, stock appreciation rights, restricted stock, or any combination of each, for no more than 20,000 shares over the life of the plan.” The example concludes that options granted under the plan do not fail to be performance-based compensation merely because the compensation committee has discretion to determine the types of awards or issue non-performance-based awards under the plan. This example appears to confirm that an aggregate, per-employee limit on stock-based compensation is permitted.

This result is logical and consistent with the intent of Congress that “a third party unfamiliar with the compensation arrangement could determine the maximum potential amount of compensation that could be paid or the formula under which such compensation could be paid.”\(^7\) A per-employee limit on stock-based awards granted during a specified period effectively provides the maximum number of Stock Rights that can be granted under the plan to any one employee, because the grant of any other type of equity award, whether in the form of restricted stock, restricted stock units, or other stock-based awards, merely reduces the number of Stock Rights that could be granted during the specified period.

The Committee believes that the technical approach of the Proposed Regulations will result in additional scrutiny regarding section 162(m) plan designs. Accordingly, it would be helpful to taxpayers and practitioners if the Service would confirm in the relevant portions of the Regulations that legitimate plan designs that use an aggregate per-employee share limit continue to be permissible.

2. Effective Date

**Issue**

The preamble to the Proposed Regulations states that the regulations are proposed to be effective upon the publication of the final Regulations.\(^8\) However, Proposed Regulation section 1.162-27(j)(2)(vi) provides that the clarifications to the per-employee limit will apply on or after June 24, 2011 (the “Per-Employee Effective Date”).\(^9\) It appears that the intent is that the Per-Employee Effective Date will apply, rather than the date of publication of the final Regulations. In either case, the effective date raises issues for corporations that took a position based on the current language of the Regulations and have existing, shareholder-approved plans that have only an aggregate maximum without a per-employee component.

**Recommendation**

We recommend that the clarification of the per-employee limit be effective with respect to plans submitted for shareholder approval on or after August 8, 2011 (i.e., 45 days after publication of the Proposed Regulations); we recommend in the alternative that, if the foregoing proposal is not accepted, the proposed clarification be effective after the taxpayer’s first shareholder meeting that occurs at least 12 months after the publication date of the final Regulations.

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Explanation

The preamble to the Proposed Regulations states that the Proposed Regulations are not intended to reflect substantive changes to the Regulations, but rather are intended to clarify the Regulations. The preamble to the Proposed Regulations notes that in the preamble to the 1993 proposed regulations under section 162(m), the Service stated that a per-employee limit was intended. However, the text of the Regulations did not make this point entirely clear. While the text of the Regulations requires a plan to limit the number of shares with respect to which Stock Rights may be granted to “any employee,” the rule could encompass an overall limit since such a limit would prevent any employee from receiving a grant in excess of the overall limit. Although we believe that many equity plans include an explicit per-employee limit, there are instances in which corporations have relied on an interpretation of the Regulations that a plan aggregate maximum effectively provides a per-employee limitation.

Applying the clarification to Stock Rights that have already been granted would put corporations in the position of having to revisit prior approaches, and possibly prior financial reporting, in light of new language in the final Regulations. A similar concern also applies to Stock Rights granted on or after the Per-Employee Effective Date under existing plans, because there is no way to “fix” an existing plan without an explicit per-employee limit short of the time-consuming process of re-submitting it for shareholder approval. Accordingly, we suggest that the clarification in the Proposed Regulations apply only to stock-based compensation arrangements that have not already been submitted for shareholder approval. Under this approach, any awards under plans that were previously shareholder-approved would be subject to the existing language of the Regulations, allowing companies to remain in the same position they were in before the Proposed Regulations, while permitting the Service to pursue the “explicit per-employee limit” interpretation of the Regulations if it chooses to do so with respect to those awards. If the Service wishes to clarify its position further, a statement could be made in the preamble to the final Regulations that the Service is not implying in the final Regulations that a failure to include an express per-employee limit was previously permitted.

II. Restricted Stock Units and Phantom Stock Paid by Companies that Become Publicly Held

Regulation section 1.162-27(f)(1) currently provides that, in the case of a private company that becomes publicly held, the $1 million deduction limit imposed by section 162(m) does not apply to “any remuneration paid pursuant to a compensation plan or agreement that existed during the period in which the corporation was not publicly held.” In the case of an initial public offering (an “IPO”), the transition relief applies only to the extent that the prospectus accompanying the IPO disclosed information concerning the company’s existing compensation plans or agreements and complied with all applicable securities laws (the “IPO Transition Rule”). A company going public may rely upon the IPO Transition Rule until the earliest of: (i) the expiration of the plan or agreement;

\[10\] Reg. § 1.162-27(f)(1).
(ii) the material modification of the plan or agreement; (iii) the issuance of all stock and other compensation that has been allocated under the plan; or (iv) the first meeting of the shareholders after the close of the third calendar year following the calendar year the company became publicly held through an IPO (the “Reliance Period”).\textsuperscript{11} Regulation section 1.162-27(f)(3) further provides that relief under the IPO Transition Rule is available for “any compensation received pursuant to the exercise of a stock option or stock appreciation right, or substantial vesting of restricted property,” granted under any such plan or agreement, so long as the grant is made before the end of the Reliance Period.

1. Treatment of Restricted Stock Units and Phantom Stock Under the IPO Transition Rule

\textbf{Issue}

In Private Letter Ruling (“PLR”) 200406026 (Nov. 3, 2003) and PLR 200449012 (Aug. 12, 2004), the Service held that restricted stock units granted during the Reliance Period under a compensatory plan that met the requirements of the IPO Transition Rule were exempt from section 162(m). Specifically, PLR 200449012 reasoned that “[a] grant of a restricted stock unit is stock-based compensation that is the economic equivalent of a grant of a restricted share of common stock.”

Under the Proposed Regulations, relief under the IPO Transition Rule for stock-based compensation would be limited to Stock Rights and restricted stock granted during the Reliance Period. As a result, amounts deductible with respect to Stock Units would be protected from the limitations under section 162(m) only if settlement or payment of such awards occurs during the Reliance Period. The rationale for this treatment set forth in the preamble to the Proposed Regulations\textsuperscript{12} is that Treasury had previously concluded in the mid-1990s that “there is not adequate justification for a further expansion of the 1994 expansion of the prior regulatory transition relief.”\textsuperscript{13} As discussed below, we submit that this position does not reflect current equity-granting preferences, is not relevant to the tax policy purposes of section 162(m), imposes unnecessary burdens on taxpayers and discourages the use of a permissible form of equity compensation that aligns favorably with corporate governance best practices.

\textbf{Recommendation}

We recommend that Stock Units, regardless of the manner of settlement, should be treated in the same manner as restricted stock for purposes of the special rule for stock-based compensation under Regulation section 1.162-27(f)(3).

\textsuperscript{11} Reg. § 1.162-27(f)(2).
\textsuperscript{13} Preamble to the 1994 final Regulations under section 162(m), 60 Fed. Reg. 65,537 (1995).
Regulation section 1.162-27(f)(3) expressly exempts forms of stock-based compensation from section 162(m) even though the related deductions for this compensation could be taken outside of the Reliance Period. This regulatory framework evidences recognition that basing the IPO Transition Rule for stock-based compensation on when the employer is entitled to take a deduction, as opposed to when an award is granted, would severely limit the utility of this relief and constrain the compensation choices of companies when becoming a public company. Given current equity granting practices, which have evolved significantly since the mid-1990s, we believe the list of protected forms of equity compensation in the Proposed Regulations is unnecessarily limited and has the potential to adversely affect how companies choose to compensate their employees.

The executive compensation landscape has changed dramatically since the Regulations were issued under section 162(m) in the mid-1990s. The prior omission of Stock Units from the types of stock-based compensation qualifying for relief under the IPO Transition Rule pursuant to the special rule for stock-based compensation under Regulation section 1.162-27(f)(3) should be reconsidered for reasons that include the following:

- A 1992 Congressional Research Service Report surveyed the types of long-term incentives among American companies and found that 70% of the 350 largest companies used restricted stock grants and only 6% used “phantom stock.” The corresponding percentages for “major industrial companies” were 41% and 8%, respectively. Today, however, usage of restricted stock units far exceeds the use of restricted shares.\(^{14}\) If performance shares are treated as a form of restricted stock units,\(^{15}\) as we believe to be appropriate, the change in equity compensation granting practice is even more dramatic. One survey, published in March 2011 by Meridian Compensation Partners, LLC, indicated that 60% of the surveyed companies granted restricted stock units and only 36% used restricted shares, and the same survey indicates that 79% of the responding companies are using performance-based full value awards (performance shares or performance units settled in cash) in their long term incentive programs.

- Stock Units have gained prevalence for legitimate business reasons, some of which are rooted in corporate governance concerns. For example:

\(^{14}\) The prevalence of restricted stock units, favored nearly two to one over restricted share awards, in the technology sector was recently documented in a study that covered the 100 largest publicly traded technology companies in the U.S. See DolmatConnell & Partners, The 2009 Tech100 Executive Compensation Study 16, available at http://www.dolmatconnell.com/documents/file/DolmatConnell%20%20Partners%20-%202009%20Tech100%20Study.pdf.

\(^{15}\) Performance shares are essentially restricted stock units under which the number of shares actually issued, or the amount of cash paid in lieu of shares, is determined based on the achievement of performance targets.
(a) Stock Units allow the employer to avoid the administrative cost and burden of issuing shares of stock (which usually include voting rights) that may never be earned and vested, which is particularly a concern for awards tied to performance vesting.

(b) Stock Units allow an employer to more easily enforce clawback policies, which will eventually be required of all public companies under section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.\(^\text{16}\) Creating an incentive for new public companies to use restricted stock that may be difficult to recover seems inconsistent with today’s corporate governance standards, which are, in part, federally imposed.

(c) Stock Units provide flexibility to facilitate the accumulation of larger vested equity positions by key employees with fewer shares than is possible with restricted stock. Large vested equity positions are often viewed as providing executives with incentives to improve stock performance and as supporting the company’s risk management efforts by aligning executives’ interests more closely with the interests of the company. In this regard, Stock Units are often granted in connection with the establishment of stock-ownership guidelines, which are favored by institutional shareholder groups.\(^\text{17}\)

(d) Tax withholding is more easily accommodated and transfer agent administrative costs are reduced with Stock Units as opposed to restricted shares.

(e) Stock Units are subject to greater flexibility regarding the timing of inclusion in the grantee’s income, if the requirements of section 409A are satisfied. We note that, with the enactment of section 409A (subsequent to the issuance of the existing Regulations under section 162(m)), the potential for abusive deferrals is substantially diminished, if not eliminated, in the case of deferrals effected in accordance with the rules thereof.

(f) Stock Units facilitate the use of compensation awards that allow employees to receive shares in excess of the nominal grant number in cases in which applicable targets have been exceeded. Grants of Stock Units designed in this way are functionally equivalent to larger grants of restricted shares that are subject to forfeiture when target-plus levels of performance are not achieved, but do not require the larger stock issuances and equity program consequences that would be necessary if actual restricted shares were to be transferred at the outset.

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• Compensation survey data that is used by employers to establish pay levels further demonstrates that restricted stock units are considered to be the economic equivalent of restricted shares as these two types of awards are treated as identical from a compensation perspective. This treatment is consistent with the financial accounting treatment for restricted shares and restricted stock units settled in shares under Financial Accounting Standards Board’s Accounting Standards Codification 718.

• Stock Units and restricted shares (as well as Stock Rights) are almost always issued under the same shareholder approved plan, and such approval is now mandated under stock exchange listing requirements. We note that the New York Stock Exchange has issued an interpretation that shareholder approval is not required to include the grant of restricted stock units if the existing shareholder approved equity compensation plan already permits the grant of restricted stock because the awards are considered to be the same type. When the two types of equity awards are granted under the same plan and subject to the same share authorization limit, the issuance of all stock that has been allocated under the plan will typically expire at the same time for Stock Units and restricted shares and the issuance of one will impact the ability to grant the other.

• The rationale set forth in PLR 200449012 noted above is both compelling and consistent with the approach taken by Treasury in the final Regulations promulgated under section 409A. There is no fundamental economic difference between restricted stock and Stock Units – these forms of equity compensation provide the employee with the value of a share of stock. When faced with a similar issue under section 409A – whether cash-settled stock appreciation rights should be treated differently than stock options or stock-settled stock appreciation rights – Treasury concluded, after detailed and express consideration, that all of these types of equity compensation should be eligible to qualify as stock rights.

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19 Performance shares are accounted for differently from non-performance based awards; however restricted shares and restricted stock units with identical performance conditions would be treated the same. See Compensation – Stock Compensation, Accounting Standards Codification No. 718, §10-25 (FASB).
22 Stock Units may be structured to result in the payment of cash rather than the delivery of shares, so the above statement would not apply to cash-settled Stock Unit awards. In our experience, Stock Units are not often paid in cash, however, because of unfavorable mark to market liability accounting treatment.
23 Stock Units, unlike shares, do not automatically confer voting rights and dividends. Dividends granted with respect to restricted stock units and dividends with respect to restricted shares may be treated in the same way, i.e., paid currently or at the time of vesting.
exempt from the time and form of payment restrictions under section 409A.\textsuperscript{24} To have concluded otherwise would have resulted in plan design constraints not related to the purposes of section 409A, particularly for companies that had legitimate business reasons not to issue stock in settlement of stock appreciation rights. The same conceptual approach should be applied with respect to Stock Units under Regulation section 1.162-27(f)(3).

- The material modification provisions that are included in the general transition rule prescribed in the section 162(m) Regulations further support the position that restricted stock and Stock Units should be treated in the same manner under Regulation section 1.162-27(f)(3). Regulation section 1.162-27(h)(1)(iii) sets forth rules for determining when an award of compensation is considered to have been materially modified and thus result in the grant of a new compensation award that would be subject to section 162(m). Regulation section 1.162-27(h)(1)(iii)(B) provides that modification of a compensation award to defer the payment of compensation is not a material modification if the additional amount is based on one or more predetermined investments (here, the employer’s common stock). In effect, the Regulations recognize that there is not a meaningful economic difference between awards paid at different times if the award value is tied to a predetermined investment measure. Similarly, it does not seem appropriate that an award of Stock Units made during the Reliance Period may not be exempt under the IPO Transition Rule merely on account of the time at which it is settled.

- Existing Regulations for determining whether the performance-goal requirement has been met under section 162(m) provide further support for treating restricted shares and Stock Units in the same manner for purposes of the IPO Transition Rule. Regulation section 1.162-27(e)(2)(iii)(B) generally provides that accelerations and deferrals do not result in an increase in compensation for purposes of satisfying the performance-based compensation exception if, in effect, there is no increase in the expected value of the compensation. This Regulation specifically states that, “[i]f compensation is payable in the form of property, a change in the timing of the transfer of that property after the attainment of the goal will not be treated as an increase . . . .” We believe that this rule is consistent with the principle that the date on which Stock Units granted during the Reliance Period are settled should not impact whether they are exempt for purposes of the IPO Transition Rule.

- Treating Stock Units in the same manner as restricted shares for purposes of the IPO Transition Rule is also consistent with final rules interpreting executive compensation requirements under the Emergency Economic Stabilization Act of 2008 ("EESA"), relating to the Troubled Assets Relief Program.

\textsuperscript{24} 70 Fed. Reg. 57,930, 57,933 (2005) (proposing to treat stock appreciation rights similarly to stock options, regardless of whether the stock appreciation right is settled in cash and regardless of whether the stock appreciation right is based upon service recipient stock that is not readily tradable on an established securities market.).
Section 111(b)(3)(D) of EESA required Treasury to establish standards prohibiting TARP recipients from paying or accruing any bonus, retention award, or incentive compensation to certain “senior executive officers.” A significant statutory exception, however, was provided for “long-term restricted stock.” TARP guidance issued in 2009 (the “TARP Interim Final Rule”) provides for restricted stock units to be treated the same as restricted stock under this exception. In particular, the preamble to the TARP Interim Final Rules states that “[b]ecause many TARP recipients, especially smaller, family owned community banks as well as private financial institutions, would be unwilling or unable to award restricted stock, § 30.1 (Q–1) of the [TARP] Interim Final Rule defines long-term restricted stock to include both restricted stock and restricted stock units, which can be settled in stock or cash, and which may be designed to track a specific unit or division within a TARP recipient.” The perceived public policy goals in aligning executive and shareholder interests would arguably be as great or greater under TARP, EESA and ARRA as they are under section 162(m).

Thus, adopting the Proposed Regulations in their current form would create an incentive to use restricted stock instead of Stock Units without serving the policy purposes of section 162(m) and, as discussed above, would not recognize prevailing corporate-governance and equity-granting practices.

2. Effective Date

Issue

The Proposed Regulations are proposed to become effective with respect to Stock Units under the IPO Transition Rule upon publication of the proposals as final Regulations. As such, there is no meaningful transition relief for Stock Units granted before that date – stock that is issued or cash that is paid under such awards after the end of the Reliance Period is subject to the section 162(m) deduction limitation. Employers, however, in many instances will not be able unilaterally to amend these types of awards so as to ensure that amounts can be deductible under section 162(m).

Recommendation

We recommend that if the Proposed Regulations are finalized in a manner so that the settlement of Stock Units after the end of the Reliance Period is subject to the section 162(m) deduction limitation, the proposed limitation should only apply to Stock Units

granted after the Proposed Regulations are published in final form; we recommend in the alternative that, if the foregoing proposal is not accepted, the proposed limitation should be effective after the taxpayer’s first shareholder meeting that occurs at least 12 months after the publication date of the final Regulations.

**Explanation**

We see a fundamental issue with the effective date provision. An employer can ensure deductibility going forward only by revising a contractual obligation with an employee, which in many cases has been negotiated either as part of the IPO or an employment agreement. In addition, (i) if the restricted stock units are a form of nonqualified deferred compensation subject to section 409A, it may be difficult or impossible to negotiate a workable solution that complies with the requirements of section 409A; (ii) accelerating payments to fall within the Reliance Period may violate section 409A; (iii) accelerating vesting in order to satisfy the effective date provision defeats a legitimate business goal of the employer, such as retaining the employee’s services or to incentivize achieving a performance goal; and (iv) even if a further deferral of payment designed to satisfy the effective date provision might be allowed under section 409A, an employee who has negotiated an equity award to be payable at a certain time may justifiably not consent to this type of change, as it might result in multiple years of additional deferral.

Given the considerations described above, we view the effective date that we have recommended as a reasonable baseline for relief. However, we suggest that Treasury and the Service give consideration to further flexibility in the effective date (particularly in light of the prior PLRs), such as applying the proposed limitation only to Stock Units granted by a public company with an IPO that occurs after the Proposed Regulations are published in final form.

3. **Treatment of Restricted Stock Units and Phantom Stock Under the Spinoff Transition Rule Applicable to Subsidiaries That Become Publicly Held**

**Issue**

Regulation section 1.162-27(f)(4) currently provides that in the case of a member of an affiliated group (as defined for this purpose) that becomes a separate publicly held corporation, the requirements of Regulation section 1.162-27(e) will be deemed satisfied for any remuneration paid to covered employees of the new publicly held corporation if certain requirements are satisfied (the “Spinoff Transition Rule”). These requirements include the satisfaction of the performance-goal requirements set forth in subsections (e)(2), (e)(3) and (e)(5) of Regulation section 1.162-27. The transition relief applies only “for compensation paid, or stock options, stock appreciation rights, or restricted property granted, prior to the first regularly scheduled meeting of the shareholders of the new publicly held corporation that occurs more than 12 months after the date the corporation becomes a separate publicly held corporation” (the “Spinoff Reliance Period”).

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29 Reg. §1.409A-2(b)(7)(i).
Compensation paid and equity awards granted after that date must satisfy all of the section 162(m) requirements, including the shareholder approval requirement.

The language in Regulation section 1.162-27(f)(4), “compensation paid, or stock options, stock appreciation rights, or restricted property granted,” is similar to the language in Regulation section 1.162-27(f)(3) insofar as it relates to the grant of restricted property, and not Stock Units. The Proposed Regulation amends only Regulation section 1.162-27(f)(3). In so doing it refers to subsections (f)(1) and (f)(2) of the Regulation – not to subsection (f)(4) – and states that “[t]his paragraph does not apply to any form of stock-based compensation other than the forms listed in the immediately preceding sentence,” which does not include Stock Units.

**Recommendation**

We recommend that Stock Units, regardless of the manner of settlement, should be treated in the same manner as restricted stock for purposes of the Spinoff Transition Rule under Regulation section 1.162-27(f)(4); we recommend that, if they are not, the same general effective date approach as set forth in item 2 above should apply.

**Explanation**

It is not clear whether the intent of the Proposed Regulation was to have the identical interpretation of the similar limitations on stock-based grants covered under both the IPO Transition Rule and the Spinoff Transition Rule. If the final Regulations do not treat Stock Units as equivalent to restricted stock for all purposes, then the final Regulations should nevertheless not extend the new rule in the Proposed Regulations (which is presently proposed to be applicable only for purposes of subsections (f)(1) and (2)) to subsection (f)(4). Thus, Stock Units should be treated as equivalent to restricted stock for purposes of subsection (f)(4), whether or not treated as equivalent for purposes of subsection (f)(1) and (2).

We reiterate here our comment made above equating Stock Units to restricted shares. In our view, the basis for interpreting restricted shares as including equivalent types of equity awards such as performance-based restricted stock units and performance shares is even more compelling in the spinoff context for the following reasons:

- A Stock Unit grant by definition will have already satisfied three key requirements of section 162(m) by being performance-based with targets set and certified by the required outside directors. In addition, the requirement for disclosure to shareholders will have been substantially satisfied because the compensation program and certain of the awards will have been described in the publicly filed documents relating to the spinoff (although there is no condition in the Spinoff Transition Rule to that effect).

- Whether the achievement of the performance target is a pure vesting condition or also determines the number of shares actually delivered should be irrelevant as, in
both cases, the performance requirement that is at the core of section 162(m) will have to be satisfied.

• The pre-spinoff grants will more likely include multi-year vesting periods with service and/or performance requirements (typically covering a three-year period), as is prevalent among public companies. The transition period in this case is short (less than two years), as contrasted to more than three years under the IPO Transition Rule.

• Subsidiaries granting Stock Units in full compliance with section 162(m) should not find themselves with compliance issues that may be difficult or impossible to address merely because they are later spun off.

• Failure to grant this relief risks undermining the ability to grant multi-year performance awards, which have become common in many long-term incentive programs as public companies increasingly seek to respond to institutional demands to link long-term pay to performance. (In some instances, a spinoff company’s multi-year performance awards may be tied to the performance of the parent and truncated at the time of the spinoff, but this will depend on the specifics of the award.)

If the final Regulations do not treat Stock Units as equivalent to restricted stock for all purposes, then at a minimum the final Regulations should give relief for the grant of pre-spinoff Stock Units for purposes of subsection (f)(4), for the reasons noted above. Where grants in full compliance with all section 162(m) requirements have been made with respect to employees of a subsidiary that has been part of a group including a public company, those grants should not become non-compliant merely because actual payments are made after the subsidiary has been spun off. We believe that a contrary rule would place all grants of Stock Units in jeopardy of later disqualification without any non-compliant behavior by any party.\(^\text{30}\)

\(^{30}\) In theory, it would appear that a spun-off subsidiary could go back to its public shareholders regarding approval of pre-IPO grants of Stock Units, although we would suggest that such a step would increase uncertainty, unnecessarily interfere with the spun-off corporation’s corporate governance and otherwise result in substantial costs and inefficiencies, and should not be required.